THE WALL STREET JOURNAL ONLINE

July 12, 2004

ASIAN BUSINESS NEWS

Dollar Could Buy Trouble

If Currency Weakens, Asian Central Banks Risk Sparking Inflation

By PHILLIP DAY
Staff Reporter of THE WALL STREET JOURNAL
July 12, 2004; Page A15

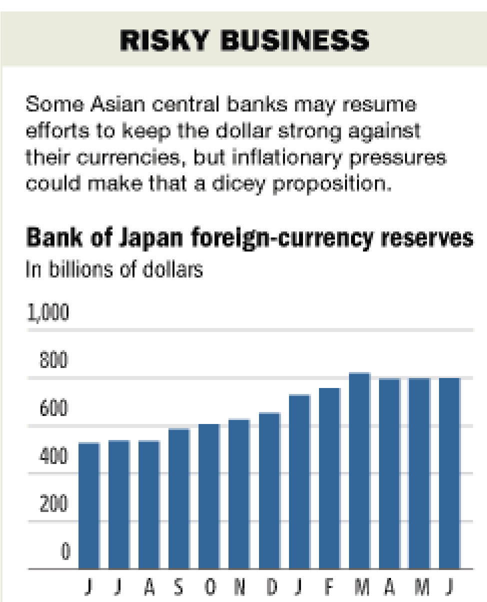
SINGAPORE -- It has been three months since Asian central banks stopped fighting currency markets. But this may be just a lull in the battle.

Should the dollar start to weaken significantly once again -- as it easily could -- Asian central banks could be back in the markets, throwing their weight around once more. "If the dollar resumes its structural decline, very quickly we would see a number of Asian central banks come back into the market," says Allison Montgomery, senior regional currency strategist at WestPac Bank Corp. in Sydney, Australia.

Unlike the most recent round, though, Asian central banks would risk sparking domestic inflation by intervening, at a time when rising prices are starting to be a worry in some economies in the region.

All else being equal, rising interest rates should add strength to a currency. In the case of the dollar, talk that began in March of a Federal Reserve rate increase put enough punch into the currency to end the contentious battle Asian central banks had been waging to keep their currencies from strengthening too much against the dollar and crimping their nations' export growth.

But all else isn't equal in this case, and the factors that originally led to the dollar's weakening could start moving currency markets again at any time. The U.S. current-account deficit continues to grow. Economists haven't put aside their concerns about the rising U.S. fiscal deficit, nor have their worries subsided about the lack of savings by U.S. consumers. All these factors could set the dollar on a weakening trend once again.



At stake are the profits of Asian exporters, because a weaker U.S. dollar would either force them to raise prices in dollar terms and risk losing sales, or keep dollar prices steady and see fewer profits in their home currencies. But should Asian governments resume their attempts to keep their currencies down, the U.S. and European companies their exporters compete against could decry it as an unfair trade strategy, raising pressure on their politicians to act.

Throughout last year and into the spring, dollars were pouring into Asia as trade boomed and as foreign investors bought into Asian stocks and bonds. Governments in Japan, South Korea and elsewhere kept steadily buying dollars to keep their currencies from appreciating too much against the dollar. Economists at UBS estimate that foreign-currency reserves held by Asian central banks were growing by $80 billion a month by the first quarter of this year.

In the end, it was U.S. central bank policy that allowed Asian central banks to step away. Fears of growing U.S. inflation and anticipation of rising U.S. interest rates reversed the flows of investment that had been a key driver of Asian currency strength.

The Japanese central bank, for example, hasn't intervened in currency markets since the middle of March. UBS estimates total Asian foreign-currency reserves grew by $17 billion in May.

Currency markets have stabilized at rates that are fairly comfortable for Asian exporters. Profits have been picking up and companies are spending more. Japan's key business survey shows companies are more confident than they have been since that country's bubble years of the 1980s.

Asian governments are banking on the idea that profits from healthy exports will trickle down into domestic economies. If that happens -- and in places like Japan the early signs are that it is beginning -- domestic growth could lessen dependence on exports and lower the need for such tight control of currency levels.

But those better prospects also could herald the return of investment flows and renew pressure on Asian currencies. Indeed, while global investors dumped $1.8 billion in Asian stocks in May, they started returning to select markets in June, according to fund-tracker Emerging Portfolio Fund Research. In the two weeks ended June 30, global investors put $712 million into Japanese equity funds, the company said.

UBS predicts Asian foreign-currency reserves will grow by $50 billion a month in the second half.

Should Asian central banks jump back into currency markets, renewed political flak isn't the only danger they will face. Intervening can contribute to inflation, as central banks essentially print new money to buy dollars. They issue bonds to soak up some of that new money, but such "sterilization" isn't 100% successful, especially at the levels needed during the last round of currency battles.

Inflation hasn't been a big worry in Asia during the past few years. Indeed, many Asian central banks faced the opposite problem -- deflation -- and their currency-market activity may have helped alleviate that.

But now it is a different story in places such as China and South Korea. Inflation has been picking up in both countries, and the inflationary effects of intervention (or in China's case, keeping its currency pegged to the dollar, regardless of inflows of dollars) could tip the balance, forcing them to raise interest rates sooner than the economy's health warrants.

Those worries aren't stopping Asian central banks from preparing a renewed defense of currency levels they feel necessary for export growth, however.

This month, South Korea announced it would raise as much as 11 trillion won ($9.57 billion) in the second half to intervene in currency markets, should the need arise. That is on top of 7.8 trillion won already allocated and would set aside an amount equal to 2.8% of South Korea's gross domestic product specifically to intervene in currency markets.

"We'll use it to the maximum limit if necessary," said Choi Joong-Kyung, director-general of the Finance Ministry's International Finance bureau. "Our foreign-exchange policy remains resolute: We'll use every won to protect the foreign-exchange market from speculators and from moves that go against economic fundamentals." (See related article[1].)

Even so, on Friday South Korean policy makers -- facing a fragile domestic economy and growing inflationary pressures -- appeared to signal a neutral stance on the won's exchange rate. While South Korea's central bank worries that a lower won would stoke price increases, the finance ministry, which has the upper hand on currency policy, doesn't want a strong won to hurt exports, the economy's only source of strength. The result, currency-market participants say, is that Seoul may let the won rise a bit above its current three-month high but that the Ministry of Finance and Economy and the central bank would both like to see the dollar continue trading narrowly around 1,150 won.

Japan also is keeping its powder dry. Last year, Japan sold a record ¥20 trillion ($184.77 billion) in currency markets, and dumped an additional ¥15 trillion or so in the first three months of this year. The Japanese central bank's borrowing limit for the most recent fiscal year, which ended March 31, was ¥79 trillion for the money it needed for those interventions, among other things. For this fiscal year, it has raised the borrowing limit to ¥140 trillion. That is about 2.5% of Japan's annual GDP.

--Hye-Seung Seo in Seoul, South Korea, contributed to this article.

Write to Phillip Day at phil.day@wsj.com[2]

URL for this article:
http://online.wsj.com/article/0,,SB108958567874260833,00.html

Hyperlinks in this Article:
(1) http://online.wsj.com/article/0,,SB108957120975460568,00.html
(2) mailto:phil.day@wsj.com